In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 382

CARL L. DANIELSON AND PAULINE S. DANIELSON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HELEN P. SHERMAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ESTATE OF JACOB F. SCHAFFNER, DECEASED, ELIZABETH SCHAFFNER AND ERWIN MARSCH, EXECUTORS, AND ELIZABETH SCHAFFNER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HUGH E. MCLENNAN AND KATHERINE MCLENNAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

A seller of the stock of a corporate business commonly covenants not to compete with the buyer for a

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specific period in a given locale. The amounts paid for the ~~business~~ stock result in a capital gain or loss to the seller. Money paid for a covenant not to compete is, on the other hand, ordinary income to the seller and may be amortized by the buyer. *E.g., Ullman* v. *Commissioner*, 264 F. 2d 305 (C.A. 2). The question presented here is whether sellers of ~~a business~~ such stock, who simultaneously covenanted not to compete with the buyer, may ignore, and thereby secure capital gain treatment of, the portion of the total price which the written contract ascribed to the covenant on the ground that the covenant was without "substance," even though there is no evidence of fraud or other grounds that could be invoked as a defense in a suit by the buyer against the seller.

Petitioners were stockholders of a corporation engaged in the small loan business in Butler, Pennsylvania. They sold their stock to Thrift Investment Corporation by an agreement that gave each petitioner $374 per share. Through a covenant in the agreement each agreed not to compete with Thrift for six years in the Butler area, except through owning stock in another small loan corporation. The contract stated that each seller was being paid $222 for each share of stock he owned, and an additional $152 per share for a "non-compete" agreement.

Thrift claimed a deduction based on amortization over a six year period of the amounts apportioned to the noncompete agreements. Petitioners, however, reported the entire amount received as resulting from the sale of their stock. The Commissioner issued notices of deficiency based on the view that the

amounts apportioned to the non-compete agreements were ordinary income.

In a resulting suit for redetermination the Tax Court ruled in favor of petitioners, holding that "the amounts allocated by Thrift to the covenants not to compete were in reality that part of the purchase price of the stock representing a premium on corporate receivables" (Pet. App. 61–62). The United States Court of Appeals for the Third Circuit, which *sua sponte* granted rehearing *en banc*, vacated the Tax Court decision by a vote of 4 to 3. The appellate court, in adopting a rule which the Commissioner proposed, held (Pet. 22–23):

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.

This rule is consistent with positions expressed by other circuits in comparable circumstances, and is not in conflict with decisions of this Court. There is no occasion for further review.

1. The Second, Fifth, Sixth, Ninth, and Tenth Circuits have each decided at least one case factually similar to the present one. Althought no prior opinion has expressed the verbal formulation adopted here, the courts of appeals have not allowed a single taxpayer to avoid a written allocation of payment to an agreement not to compete.

Hamlin's Trust v. *Commissioner*, 209 F. 2d 761 (C.A. 10) was first, and on its facts bears the greatest resemblance to the present case. The taxpayers argued that "the basic transaction never involved any agreement in respect of the relative value of the stock and the covenant." 209 F. 2d at 764. In ruling that the tax consequences must nonetheless rest on the written apportionment of part of the purchase price to the covenant, the Tenth Circuit reasoned (*id.* at 765):

> It is reasonably clear that the sellers failed to give consideration to the tax consequences of the provision, but where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences. While acting at arm's length and understandingly, the taxpayers agreed without condition or qualification that the money received should be on the basis of $150 per share for the stock and $50 per share for the agreement not to compete. Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction. * * *

Next came *Ullman* v. *Commissioner*, *supra*. In expressly agreeing with the Tenth Circuit's decision in *Hamlin*, the Second Circuit stated (264 F. 2d at 308):

> when the parties to a transaction such as this one have specifically set out the covenants in the contract and have given them an assigned value, strong proof must be adduced by them in order to overcome that declaration. * * *

The same "strong proof" articulation has been accepted in the Fifth Circuit, *e.g.*, *Barran* v. *Commissioner*, 334 F 2d 58, and the Sixth, *Montesi* v. *Commissioner*, 340 F. 2d 97.

The Ninth Circuit has also approved the rule of *Hamlin*. In a case where the "taxpayers probably have been maneuvered by their purchaser into a big tax disadvantage," that court held: "Third parties may question the resolutions of parties to a contract, but in the absence of fraud it is not ordinarily open to the bargainers to do so." *Rogers* v. *United States*, 290 F. 2d 501.

The reasoning of *Hamlin* is in obvious accord with that adopted by the Third Circuit. Petitioners' claim is that the "strong proof" language, first used in *Ullman*, is in conflict with the result below. But their position utterly ignores that *Hamlin* was the foundation for the Second Circuit's decision in *Ullman*, that most subsequent decisions have relied on both *Hamlin* and *Ullman*, and that not a single court of appeals has suggested a conflict between *Hamlin* and *Ullman*. Petitioners themselves must recognize this lack of conflict, since they cite both cases as evidencing the "strong proof" rule (Pet. 12, n. 7).

What constitutes "strong proof" has not been defined by the courts which have used the phrase. Nothing in the cases suggests that any other circuit would have ruled for petitioners on the present record. Rather, the import of the decisions is that the "strong proof" called for would be tantamount to proof that

fraud or a subterfuge was committed during the negotiations. Thus, as the Third Circuit stated here (Pet. 27):

> the "strong proof" rule would require that the taxpayer be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement.

2. Petitioners are wrong in their contention that the Third Circuit "undercuts" the rule that tax consequences must follow the "substance" and not the "form" of a transaction.[1] That rule allows the courts, in determining tax consequences, to ignore a label that contracting parties attach to their deal if the substance of the transaction makes the label inappropriate. Thus in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, 255, a purported transfer and leaseback was held to be a mortgage under the "established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money." And in *Bartels* v. *Birmingham*, 332 U.S.

[1] Contrary to petitioners' contention (Pet. 10, n. 5) Section 7453 of the Internal Revenue Code has nothing to do with the determination of what is "substance" and what is "form." Petitioners may intend to argue that, in requiring the Tax Court to adhere to the rules of evidence applicable in the District of Columbia, Congress has required that parol evidence be admissible in tax litigation to the extent the District of Columbia courts would receive it in contract disputes. See Judge Staley's dissenting opinion below, at Pet. 35–36. But this position ignores the fact that the "parol evidence" rule is one of substance, and not one of evidence. *E.g.*, 4 Williston on *Contracts* § 631 (3d ed.); IX Wigmore on *Evidence* § 2400 (3d ed.); 3 Corbin on *Contracts* § 573. Moreover, parol evidence is generally used to explain ambiguities or supply omissions of contracts.

126, dance band leaders were found to be for Social Security purposes the employers of musicians, even though contracts called the dance hall operators the "employers", because the band leaders had the usual duties of the employer. In each case the "form" that the parties attached to the transaction was plainly a fiction, when compared to the rights and obligations each party had.[2]

It is doubtful whether petitioners have made any effective showing that the substance of their agreement with Thrift impeaches the form. From the outset of the negotiations, Thrift demanded an agreement not to compete, and petitioners agreed. In point of substance the contract restricted petitioners' right to compete with Thrift, and Thrift could enforce the agreement.

Petitioners make no contrary claim. Their claim is that Thrift paid more for the covenant, and less for the stock, than it should have.

But Thrift computed the amount it apportioned to the covenant in the manner usual in Thrift's other transactions of this nature. The record shows, moreover, that in bargaining with petitioners Thrift considered the tax consequences of the apportionment, and

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[2] There is no relevance to the present circumstances in such cases as *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481, affirming, 83 F. 2d 518 (C.A. 3). (See Pet. 11.) The problem there was the net tax consequences of several interrelated contracts with respect to money which one document recited was the "consideration" paid by one of several parties to a second. The case is but an example of the rule that extrinsic evidence may be used to determine whether consideration was in fact paid as recited. Compare *Richards* v. *Boyd*, 344 F. 2d 754, 757 (C.A. 3).

increased its offer accordingly (Pet. 16). The "form" of apportionment had a substantive effect on the price paid.

In any event, to allow a party in petitioners' place to litigate with the tax collector the fair value of the covenant would have untoward and undesirable results for taxpayers and government alike. Notwithstanding the bona fides of his bargaining, a party to a contract would never know whether the courts, at the instance of the other party, would remake the terms with a resulting change in tax consequences. The only alternative would be for a party such as Thrift whose legitimate tax planning was thus frustrated to file a separate suit and seek a different result in a different forum, thereby defeating the public interest in uniform administration of the tax laws.

In the ordinary case,

> [t]he tax avoidance desires of the buyer and seller * * * are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants, and the true value of them in money. [*Ullman* v. *Commissioner*, *supra* at 308.]

In virtually every case one party or both will consider the tax results of a bargain and adjust his negotiating stance accordingly. That happened here. Thus, the presumed tax consequences of the transaction increased the total amount paid petitioners. To permit petitioners then to attack the provision which allocated a specific sum to the agreement not to compete, absent proof of the type which would negate it in an action between petitioners and Thrift, would

grant petitioners a unilateral reformation of the contract and a resulting windfall. Nothing in the Tax Code or in any decision of any court calls for enriching petitioners by allowing them so to remake a closed and completed transaction to their own tax advantage.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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